February 7, 2025

The Secretary
Ontario Securities Commission
20 Queen Street West
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Toronto, Ontario M5H 3S8
Email: comments@osc.gov.on.ca

Re: Ontario Securities Commission Consultation Paper 81-737 – Opportunity to Improve Retail Investor Access to Long-Term Assets through Investment Fund Product Structures

To Whom it May Concern:

We are providing the following comments in response to the Ontario Securities Commission's (the "OSC") Consultation Paper 81-737 – Opportunity to Improve Retail Investor Access to Long-Term Assets through Investment Fund Product Structures (the "Consultation Paper"). This letter represents the general comments of the undersigned members of the Canadian Anti-Monopoly Project ("CAMP") and Social Capital Partners ("SCP"). Our comments are being submitted without prejudice to any position taken or that might be taken in the future by CAMP, SCP or any of the undersigned. Capitalized terms used in this letter that are not defined have the meanings attributed to them in the Consultation Paper.

We have deep concerns regarding the proposals set forth in the Consultation Paper. CAMP and SCP are focused, among other matters, on educating Canadians and our policymakers about the risks associated with buyout private equity funds and the harms they can cause. CAMP published "The Private Equity Playbook: How buyout firms extract rather than build value and what to do about it" and CAMP and SCP jointly hosted a virtual talk with some of the leading private equity critics to educate Canadians about how buyout private equity operates and how it impacts our economy and communities. Our perspectives are rooted in nearly a decade of first-hand legal and exempt-market dealer industry experience, working with or advising fund managers and/or their portfolio companies.

It is completely understandable why the OSC would want to further investigate improving retail investor access to these private market ventures as private capital fund assets under management have grown fifteen-fold over the last 25 years[i] and our pension funds are some of the biggest investors in these asset classes globally. This growth has led to an unfortunate and corresponding decline in our public markets. Canada's public exchanges lose approximately 60 operating companies on average each year and once they are taken private, they almost always stay private.[ii] Ontario retail investors are undoubtedly losing investment opportunities as our public companies continue to be taken private or are remaining private. This is not only bad for Ontario investors but also risks further instability in our public markets as the listing base shrinks and homogenizes. We believe the migration to the private markets is misguided and is based on complex and misleading information. Rather than increasing access to investment opportunities in Long-Term Assets for retail investors, we believe revitalizing the public company regulatory regime will be more beneficial for retail investors and a better use of the OSC's limited resources. Capital will return to the public market if regulators can find a better balance between necessary public disclosure and excessive regulatory burdens. Our public markets are more accessible, democratic and liquid and thus more beneficial to retail investors. Those who will benefit most from improving retail investor access to Long-Term Assets are the investment fund managers who collect sizeable fees (most of which come from non-performance)[iii] from such investments.

However, if the OSC does choose to improve retail investor access to Long-Term Assets, full, true and plain disclosure regarding fund rates of return, conflicts of interest (most notably, fees) will be paramount in order to protect retail investor interests. Notwithstanding the forgoing, we contend that retail investors interests will be better served by existing public markets. Our comments with respect to improving retail investor access to Long-Term Assets, most notably buyout private equity funds, can be summarized as follows:

1. *Private equity fund returns are complex and often misleading:*

   In his paper, "The tyranny of IRR" Ludovic Phalippou, author of the bestseller 'Private Equity Laid Bare', and professor of Financial Economics at Saïd Business School, University of Oxford, suggests that the primary motivation for the dramatic increase in allocations to private capital funds is an expectation of significantly superior returns. His replicated research posits that these expectations are misguided. The paper highlights that the since-inception Internal Rate of Return ("IRR") does not accurately reflect a genuine rate of return. Annual performance figures for private capital funds are often reported as an IRR and while the Net Present Value of an illiquid asset is well defined, a rate of return isn't. His analysis demonstrates, using MSCI (Private-i) data, one of the most comprehensive databases available, using the entire spectrum of private capital funds (12,306 funds since 1970, with a total size of $10.5 trillion), that such funds only had a direct alpha of 1.4% per annum over the S&P 500 index, which is not much of an illiquidity premium.[iv] Phalippou also asserts that the fact that IRR is influenced by early distributions makes it possible for fund managers to strategically manipulate IRR. Managers can increase IRR by quickly exiting successful investments while retaining the less profitable ones or utilizing subscription credit lines to make earlier investments rather than calling capital from investors.[v] These workarounds have become more common as rising interest rates made it tougher for funds to generate cash in the traditional way—by selling companies and paying back investors. As a result, it's getting harder to tell apart managers who excel at buying and selling companies from those who lean more on creative accounting and financial tactics.

All of the press articles and comments reviewed by Phalippou, including some from leading specialist financial publications or practitioners, portray IRR as a rate of return. He believes a plausible hypothesis for the significant increase in the assets under management of private capital funds is therefore that investors are favorably swayed by these exceptionally high figures that look like return figures. Phalippou further asserts that most of the individuals making decisions about investment in private equity are committing capital that is not their own. These decision makers may be aware that IRR does not represent an actual rate of return, however it may serve their interests to present IRR as an indicator of performance to their superiors.

In his most notable paper "An Inconvenient Fact: Private Equity Returns & The Billionaire Factory", where Phalippou argues that private equity ("PE") firms have been more successful in minting new multibillionaires amongst their ranks than outperforming the market, he tries to make sense of this aberration:

> "*Why are trustees, investment teams, external managers, consultants, not seeing through this? Maybe because their livelihood depends on them not seeing it, especially for consultants. Net-of-fee performance of PE funds being superior to that of public equity is the sine qua non condition for continued employment of at least 100,000 people. The importance of this condition might explain why the mantra of 'PE outperforms' has for many people, who work in and around PE, become a quasi-religious article of faith. Merely to question it is considered heresy: either you believe and you are one of us, or you question the existence of outperformance and you are an enemy.*"[vi]

2. *Fund Managers Collect Excessive Fees:*

Private equity fund managers are typically compensated with a management fee of approximately 2% of assets under management as well as 20% of capital gains in excess of a hurdle rate (typically around 8%). As assets under management grow, so will management fees. Over the past decade, private-equity assets managed for all types of investors have roughly tripled, but the fees these firms collect have risen sixfold.[vii] Research has shown that the fraction of costs attributable to non-performance fees for private capital funds is 53% to 75%[viii], which raises the question as to whether fund managers interests are aligned with investors. Fee-drag on returns is also estimated to be as high as 7.9% per year for buyout funds.[ix]

Many traditional institutional investors have maxed out their capital allocations on Long-Term Assets and some are even reducing their capital allocations; retail investors are the last frontier for these fund managers. Retail investors have little to no Long-Term Asset allocations and are ripe for the taking. Bain estimates that fee revenue for private market investments will double to $2 trillion by 2032, with private equity and venture capital remaining the largest categories.[x]

3. *Conflicts of Interest*

The incentives and structures for Long-Term Assets can bring about many conflicts of interest. Some of these conflicts will arise among investors, between investors and fund managers and between investors and consultants.

Side-letters and other preferential treatment to larger investors, including information rights, reduced fees and co-investment rights should be limited and to the extent permitted, fully disclosed. The inherent conflict of interest between fund managers and investors could be reduced by reducing management fees to better align fund manager incentives with their investors. Consultants of all kinds are extensively used by fund managers, financial, legal, operational and more. Consultants should be independent and current and historical mandates, including fees and length of relationship should also be disclosed.

4. *Disclosure is needed for retail investors to make informed decisions:*

To preserve the integrity of our capital markets, retail investors need full, true and plain disclosure to make informed decisions. Given the inherent conflicts of interest, disclosure is imperative. This includes disclosures such as investor side letters, names of and fees paid to all consultants, detailed transaction expenses and contracts with non-arm's length parties.

Fee disclosures should be well detailed and include a breakdown of management fees and carry by portfolio company and non-performance fees as a percentage of total fees. Executive compensation of fund principals, including a breakdown of salary, bonuses, carry and other perquisites should also be disclosed. Fund principals should have to disclose their capital contributions into the fund as well as any involvement with past portfolio company bankruptcies and regulatory or legal infractions.

Disclosure needs to include clear explanations of any financial engineering tactics used, including how they might temporarily boost performance figures while possibly jeopardizing the long-term health of the affected portfolio companies. Portfolio company leverage and liquidity risks should also be disclosed.

As these investment firms expand into rolling-up professional services and businesses that serve vulnerable populations (e.g. childcare and eldercare), policymakers and the public should have access to this disclosure. Our public markets were historically where companies of scale resided, therefore there was transparency with our policymakers, journalists and general public. Less disclosure is less democratic. If companies can satisfy their capital requirements solely from the private markets, what incentives are there to go public? The transition from public to private markets will make our capital markets less democratic.

5. *Regulatory Uncertainty*

As private equity becomes better understood by policymakers, increased regulatory scrutiny is likely to follow. Easy but extractive and risky investment tactics will likely slow down or stop as regulators take action. The United States Senate Budget Committee recently issued a bi-partisan report entitled "Profits over Patients: The Harmful Effects of Private Equity on the U.S. Health Care System"[xi]. The report highlighted that private equity's financial model may pose "a threat to the nation's health care infrastructure." Sen. Sheldon Whitehouse, a Democrat from Rhode Island who led the investigation with Sen. Chuck Grassley, a Republican from Iowa, said "our investigation revealed, these financial entities are putting their own profits over patients, leading to health and safety violations, chronic understaffing, and hospital closures."

The Biden US Department of Justice and Federal Trade Commission also launched a public inquiry into serial acquisitions and roll-up strategies, a cornerstone of the private equity playbook. "Firms can use serial acquisitions to roll up markets, consolidate power, and undermine fair competition, all while jacking up prices and degrading quality," said then FTC Chair Lina Khan.

Recent amendments to the Canadian Competition Act will also likely result in a greater number of private equity transactions being reviewed by the Canadian Competition Bureau and foreshadow a stricter enforcement approach to private equity transactions going forward.

If regulatory intervention imposes limitations on private equity investment strategies, the asset class may no longer be as desirable as it once was. With retail investors possibly entering the market during this new period of regulatory scrutiny, they may have a different experience with the asset class than earlier investors.

Conclusion

While there may be few benefits to increased access to Long-Term Assets for retail investors, we contend that retail investors are best served by the public markets. Long-Term Assets provide more incentives to fund managers to grow their assets under management than returns for their investors. If the OSC does choose to proceed, retail investors will need full, true and plain disclosure, most notably with respect to conflicts of interest. There is limited research on the subject matter at hand, the lack of accessible and reliable critique is not proof that there are no problems—it means further scrutiny is needed.

The harsh truths, like those advanced by Phalippou, haven't really been acknowledged by most market participants. In an industry already tangled in layers of conflicts, misleading information spreads easily and creates an unfair, inefficient playing field, precisely what the OSC is mandated to prevent. The only fix is full transparency, fair rules, better education, and simpler structures.

Thank you for the opportunity to comment on the Consultation Paper. Please do not hesitate to contact any of the undersigned if you have any questions with respect to our comments above or wish to discuss these matters further.

Sincerely,

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